A Self-Evaluation Guide To Starting a Business Of Your Own

Stage 3

SHOULD YOU START A NEW BUSINESS OR BUY AN EXISTING ONE?

Manitoba
Industry,
Trade
and Tourism

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I

Introduction

The first two publications in this series have provided you with a means of evaluating your personal potential for an entrepreneurial career and a procedure for generating and evaluating the basic technical and financial feasibility of an idea upon which to base your own business. The obvious route to self-employment is to start a business of your own based on your idea. Another route which should be explored is the possibility of buying an existing firm. For many people it may even be their preferred course of action. Stage 3 discusses the various aspects that should be evaluated in considering whether you should start a new business or buy an existing one.

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II

How to Find a Business To Buy

Finding a business to buy is easy. There are dozens listed every day in the "Business Opportunities" classified section of the Winnipeg Free Press or the Globe and Mail as well as weekly listings in the Financial Times and the Financial Post. However, what tends to be found in these classified sections are mostly hotels, motels, restaurants and franchise propositions which are largely high risk, low profit ventures generally unattractive to most investors. In addition, many of these are failing businesses which their current owners are trying to unload.

Seeking out a business acquisition matching your desires and experiences, can be a very time-consuming and difficult process. Hundreds of businesses change hands in Canada every year, so it should be possible to find one that appeals to you if you are sufficiently determined and persistent. However, rather than being sold as a result of an advertisement in some newspaper, most businesses are sold to people who had some active business relationship with the company when it became available. It is usually not sufficient for an individual determined to acquire a business of his own to sit and wait for the right opportunity to come along. The other alternative is to go looking; to actively search for an appropriate business to acquire.

There are basically five different sources through which you may obtain information regarding attractive companies to buy.

1. The first is contact through your present business activity. Potential acquisition candidates may include present or potential competitors of your current employer, suppliers, customers, and perhaps even your present employer himself. These situations probably provide the best match between your experience and strengths and the unique requirements of the business.

2. The second source of leads results from direct independent contact with prospective acquisition candidates. This contact may involve making cold calls on firms which appear attractive or in which you have an interest. Prospective firms to contact may be identified from such sources as Chamber of Commerce directories and Trade Association membership lists. Another way to identify companies that may be for sale is by placing "acquisition wanted" advertisements in several major newspapers. In addition, you may also wish to follow up on some advertisements in the "Business Opportunities" section of the major financial papers as mentioned previously. Every now and then an advertisement may appear in these sections which would warrant your consideration.

3. A third source of leads is through professional middlemen such as business brokers and commercial real estate agents. They are professionals who typically work at bringing buyers and sellers together for a commission. This commission is typically payable by the seller and varies with the size of the deal, but may be as high as ten percent of the negotiated purchase price.

4. The fourth source of leads is through confidential advisors such as the loans officer in your bank, securities brokers, professional accountants and lawyers. These advisors are often aware of businesses that are or may be coming available for sale. Information from these sources may be difficult to obtain, however, because when it is revealed, it is typically revealed first to other clients with whom the advisor has developed some relationship over a period of time. So, although such advisors may often know about businesses that are available for sale, it may be very difficult for you to become aware of this information unless you have gained the confidence of that individual over an extended period of time.

5. The fifth source of information includes a variety of different sources such as venture capital firms, personal friends and acquaintances, and insurance brokers and agents. Essentially you should consider all individuals within your personal network of business contacts that may have access to information on attractive businesses for sale. This requires letting many of these people know that you are in the market for a business and the kind of business you are looking for. You will need

to keep reminding people of this interest so that when the information comes along there is a good probability that it will make its way back to you.

Which of these lead sources you should utilize will be a function of many factors such as the amount of time you have available, who you know within the business community, which ones seem to work best for you, and the kind of company you are looking for. You should do some experimentation with each of these sources of possible leads in order to determine the one or two which seem to work best for you.

III

Important Factors to Consider

An essential requirement for the successful purchase of an existing firm is knowing how to assess and evaluate the operation. A number of basic factors must be considered in determining the value of the business to you. Some of these factors are more complex and involved than others but each must be carefully investigated and studied. This section will discuss the most important of these concerns one at a time.

1. Why is the Business for Sale?

You should have this question in mind at all times during the evaluation of a possible acquisition. When the owner of a business decides to dispose of it, the reason presented to the public may be somewhat different from the actual facts of the situation. There are a number of reasons that owners may be quite willing to express for wanting to sell their business. For example, they may wish to retire, or want to move to another city, or, perhaps, illness is pressuring the owner to leave the business. In addition to these seemingly logical reasons for wanting to sell a business, there are a number of others which the current owner may not be quite so likely to volunteer. For example, they may be experiencing family pressures, or marital problems, or, perhaps, see a better business opportunity somewhere else. In addition, the company may need more financing than the owner can raise, or, the current market for the firm's products may be somewhat depressed. Other possible reasons might include competitive pressures such as competitors moving in with more effective products or methods or the current plant and equipment may be worn out or obsolete and the firm is no longer able to compete successfully. As well, the firm may be having to contend with new government regulations which are creating some difficulties or certain key employees may be leaving the firm to set up a business of their own.

As you can see, there are a number of possible contributing factors to explain why any business may be for sale. It is important that you retain a skeptical attitude because behind each of the offered explanations may be a number of hidden reasons for the seller wanting to dispose of the company. Such a skeptical attitude forces you to examine the situation from all angles and not necessarily accept everything you are told at face value. When the real reasons for selling are factors that may lead to the eventual collapse of the company, then the present owner may be hard-pressed to justify these reasons to you.

This is not to assume that all businesses are for sale due to negative opportunity factors. Many companies are sold to very plausible and honest reasons. However, to keep from losing your shirt as well as your savings, a detailed evaluation should be conducted in order to evaluate the true character of the business.

2. Financial Factors

An analysis of the financial statements of the firm, preferably with the help of a professional accountant, can help you assess the current health of the business. You should not fall into the trap, however, of necessarily accepting these statements as the absolute truth. Even though the statements may have been audited there are many accounting techniques that allow business owners to present a less than accurate picture of the financial situation of their company. You must be careful to ensure that the statements have not been biased in favor of the seller.

In performing this analysis there are a number of items you should check. The most important of these include:

a. The profit trend.

A study of the records of the business will indicate whether sales volume and profits have been increasing or decreasing. If they have been going up, it is useful to know which departments within the business or products within the firm's product line have accounted for this increased sales and/or profitability.

If sales and profits are declining, the question may arise as to whether this is due to a failure by the firm to keep up with the competition, its inability to adjust to changing circumstances or, perhaps, simply due to a lack of selling effort. Some experience with this type of busi-

ness situation plus a few questions directed to appropriate sources may bring out an explanation for these circumstances.

b. Ratio analysis.

For every size and type of business there are certain financial ratios that have become generally accepted as reasonable for that kind of operation. Some information on these ratios is collected and published by trade organizations and associations such as the National Retail Hardware Association or the National Association of Retail Grocers. Others have been developed by various manufacturers for use by retailers that handle their product lines. Ratios for manufacturing industries have been collected by Dun & Bradstreet, Robert Morris and Associates and other companies. A study of the ratios of any business offered for sale, compared with standard ratios for that industry and size of company, will quickly indicate any discrepancies. These discrepancies may be due to mismanagement, neglect, carelessness, or perhaps even the lack of appropriate financing.

The most frequently considered ratios include:

i. *Current ratio*. The current ratio is defined as current assets divided by current liabilities. It is a measure of short term solvency. Current assets normally include cash, marketable securities, accounts receivable, and inventories. Current liabilities consist of accounts payable, short term notes payable, income taxes payable, and accrued expenses. A general rule of thumb is that the current ratio of 2 to 1 could be considered satisfactory for a typical manufacturing business. Service firms typically have a lower ratio since they tend to have less inventory. However, extreme care should be exercised in evaluating this ratio as with applying any rule of thumb. A cash-poor firm may be unable to pay its bills even though its ratio appears to be acceptable. On the other hand many businesses with a current ratio less than the rule of thumb are quite solvent.

Too high a ratio can indicate the business is not utilizing its cash and other liquid assets very efficiently while too low a ratio may raise questions about the firm's ability to meet its short term obligations. In actual practice, however, what is more important than the absolute level of the current ratio is how the ratio is changing over time. An improving current ratio would tend to indicate improved short term financial solvency unless the business is building up excessive or obsolete inventories.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

ii. *Quick ratio*. The quick ratio is obtained by dividing current liabilities into current assets minus inventories. The quick ratio can be used to estimate the ability of a firm to pay off its short term obligations without having to sell its inventory. Inventories tend to lose their value faster than other assets if disposed of in a hurry. The quick ratio is probably a more valid test of the firm's ability to meet its current liabilities and pay its bills than the current ratio.

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}}$$

iii. *Debt to net worth*. The debt to net worth ratio indicates the firm's obligations to its creditors relative to the owner's level of investment in the business. Debt includes current liabilities, long-term loans, bonds and deferred payments; the owner's net worth includes the value of common stock, preferred stock, any capital surplus, and retained earnings. Any outstanding shareholder's loans to the business should be considered part of the owner's net worth rather than as part of the business' present debt. This ratio is commonly used by creditors to assess the risk involved in lending to the firm. For example, if the debt to net worth ratio is too high, say about 2 or 3:1, you may find it difficult to borrow additional funds for the business. Too low a ratio, on the other hand, may indicate the business is not being operated very efficiently and some profits are being sacrificed.

$$\text{Debt to Net Worth Ratio} = \frac{\text{Total Outstanding Current and Long-Term Debt}}{\text{Net Worth}}$$

iv. *Ratio of gross profit to sales.* This ratio is determined by dividing gross profit or gross margin by net sales. Gross profit is determined by deducting cost of goods sold from net sales. No general guidelines exist for this ratio as it can vary substantially among industries, or even among companies within an industry.

$$\text{Gross Profit to Sales Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}}$$

v. *Ratio of net income to sales.* This ratio is calculated by dividing net income by net sales. You may use net income either before taxes or after taxes. As with the previous ratio no general guidelines exist because of the variability among companies and industries. This figure could be as low as 1% or less for retail food stores and supermarkets to as high as 8 or 9% in some service sectors.

However, you might evaluate how these ratios compare with other similar companies or have been changing over time. If the gross or net profit to sales ratio has recently been declining, why? This may indicate the firm's costs have been increasing without a commensurate increase in prices, or perhaps, competition may have increased and the company is forced to keep its prices low in order to compete.

$$\text{Net Income to Sales Ratio} = \frac{\text{Net Income (before or after taxes)}}{\text{Net Sales}}$$

vi. *Return on assets.* This ratio is determined by dividing net income (before or after taxes) by total assets. This ratio is an excellent indicator of whether all the firm's assets are contributing to its profits and how effectively the assets are being employed. This is the real test of the economic success or failure of a business. Unfortunately, this is not an easy ratio to apply because it is a measure of the movement of assets in relation to sales and profits during a particular period of time. The methods used by accountants to determine the level of total assets in the business can have a great effect on the ratio and there are no real general or convenient rules of thumb to follow to indicate whether the current return on assets is at an acceptable level.

$$\text{Return on Assets} = \frac{\text{Net Income (before or after taxes)}}{\text{Total Assets}}$$

These ratios are calculated from information on the firm's income statement or balance sheet. Tables 1 and 2 illustrate simplified financial statements for the hypothetical Appleton Co. The value of each of these ratios for that company would be as follows:

i. $\text{Current ratio} = \frac{\$158{,}000}{\$95{,}000} = 1.66$

ii. $\text{Quick ratio} = \frac{\$78{,}000}{\$95{,}000} = 0.82$

iii. $\text{Debt to net worth ratio} = \frac{\$135{,}000}{\$50{,}000} = 2.70$

iv. $\text{Gross profit to sales ratio} = \frac{\$133{,}000}{\$425{,}000} = 0.31 \text{ or } 31\%$

v. $\text{Net income to sales ratio} = \frac{\$13{,}500}{\$425{,}000} = 0.03 \text{ or } 3\%$

vi. $\text{Return on Assets} = \frac{\$13{,}500}{\$185{,}000} = 0.07 \text{ or } 7\%$

It would appear from these ratios that the Appleton Co. is in reasonably sound shape financially. Its debt to net worth ratio is within acceptable limits and the business is quite solvent as indicated by the current and quick ratio. The other three ratios are more difficult to evaluate but would be quite acceptable for firms in many lines of business.

Table 1

THE APPLETON CO.

Balance Sheet

As of December 31, 19Y0

Assets (000's)			
Current Assets			
Cash	$25		
Accounts Receivable	53		
Inventory	80		
Total Current Assets			$158 (A)
Fixed Assets			
Machinery	40		
Less: Accumulated Depreciation	25	15	
Equipment and Fixtures	30		
Less: Accumulated Depreciation	18	12	
Total Fixed Assets			27 (B)
Total Assets (C = A + B)			185 (C)
Liabilities and Owner's Equity (000's)			
Liabilities			
Current Liabilities			
Accounts Payable	60		
Notes Payable	35		
Total Current Liabilities		95	
Long-Term Liabilities			
Notes Payable	40		
Total Long Term Liabilities		40	
Total Liabilities			135 (D)
Owner's Equity			
Capital Investment		20	
Retained Earnings		30	
Total Owner's Equity			50 (E)
Total Liabilities and Owner's Equity (F = D + E)			$185 (F)

Table 2

THE APPLETON CO.

Income Statement

For the Year Ending December 31, 19Y0

Sales	$428	
Less: Returns	3	
Net Sales		$425
Cost of Goods Sold:		
Beginning Inventory	75	
Net Purchases	297	
Cost of Goods Available	372	
Ending Inventory	80	
Cost of Goods Sold		292
Gross Profit		133 (A)
Selling Expenses		29 (B)
Administrative Expenses		
Office Salaries	60	
Interest	9	
Depreciation	10	
Other Admin. Expenses	7	
Total Admin. Expenses		86 (C)
Profit Before Income Tax (D = A−B−C)		18 (D)
Income Tax (E = 25% of D)		4.5 (E)
Net Profit (F = D−E)		$13.5 (F)

c. Tangible assets

In assessing the balance sheet of the prospective acquisition you must determine the actual or real value of the tangible assets. A physical count of the inventory must be taken to determine if the actual level corresponds to the level stated on the balance sheet. This inventory must also be appraised in terms of its age, quality, saleability, style, condition, balance, and freshness. Most large inventories will have some obsolescence. You must determine if the present inventory is consistent with current market conditions. Also, take care that the seller does not sell this inventory after you have checked it. Any consignment goods in the inventory should be clearly identified as well. This inventory evaluation is best performed by someone with considerable experience in the business. Perhaps you can hire the services of the owner of a similar but non-competitive firm to assist you in this appraisal.

You must also check the age of any outstanding accounts receivable. Some businesses continue to carry accounts receivable on their books that should have been charged off to bad debts, resulting in an overstatement of the firm's profit, and value. Generally, the older the receivables, the lower their value. Old outstanding accounts may reveal a slack credit policy by the present owner. These old accounts will have

to be discounted in determining the present value of the business.

The fixed assets of the business must also be scrutinized. You should determine if the furniture, fixtures, equipment, and building are stated at their market or depreciated value. Some questions you should ask include: How modern are these assets? Are they in operating condition? How much will it cost to keep these assets in operation? Are the assets all paid for? You must be aware of any leins or chattel mortgages which may have been placed against these assets. This pledging of assets to secure a debt is a normal business practise, however, you should know of such mortgages. Other liabilites such as unpaid bills, back taxes, back pay to employees and so on, may be hidden. You must be aware of the possibility of the existence of these liabilities and contract with the seller that all claims not shown on the balance sheet will be assumed by him.

d. Intangible assets.

In addition to the more obvious physical gooods and equipment, certain intangible assets may also have a real value to a prospective purchaser. Among the most important of these are goodwill; franchise and licensing rights; and patents, trademarks and copyrights.

You must be very realistic in determining what you can afford or are prepared to pay for goodwill. Is the public's present attitude towards the business a valuable asset that is worth money, or is it a liability? Typically few businesses that are for sale have much goodwill value. Many business owners, however, tend to place a premium on the goodwill they feel they have developed for the business. As a result you should be careful and talk to customers, suppliers, neighbors, employees, and perhaps even competitors, in order to determine if, in fact, this level of goodwill does exist.

If franchise, licensing or other rights are involved in the business, you should be certain that you understand the terms and conditions associated with such rights and that, in fact, these rights will be transferred to you upon acquisition of the company. An effort should also be made to determine the market value of any patents, trademarks, or copyrights that the company may hold. You should also make sure that these are part of the sale and do not remain with the current owner upon completion of the transaction.

e. Cash flow analysis

You must also observe the cash flows generated by the operation. A business can be very profitable, but cronically low in cash due to overly generous credit terms, excessive inventory levels, or heavy fixed interest payments. You must assure yourself that upon your entry into the business you would have sufficient inflows of cash to meet your cash outflow requirements. Constant cash problems can indicate that the business is possibly being run by ineffective management or that the firm's resources have generally been badly allocated. You must ask yourself if you have the know-how to overcome this misallocation of resources If the firm's cash flow is very low, and the long term debt is quite high, the business may be eating up its capital to pay the debt or, possibly defaulting on the debt to its lenders. If you are to contend with such issues, you may have to increase the firm's debt or be prepared to invest more capital in the business in order to ease the cash flow problem.

3. Marketing Considerations

While the previous section deals with the internal aspects of the firm's profitability, there has been no discussion of the external determinants of these internal conditions. You must be concerned with analyzing the company's markets, customers, competition, and various other aspects of its operating environment.

You must carefully examine the company's current market situation. Each market segment served by the firm must be analyzed and understood. Studying maps, customer lists, traffic patterns, and other factors can help you to determine the normal market size for the business. Once the market and its various segments are understood, the composition of these segments should be determined in order to identify the approximate number of customers in the

total market. As a buyer, you should be concerned with:

1. the company's trading area
2. population demographics
3. trend and size of the market
4. recent changes in the market
5. prediction of future market patterns.

All these factors help in determining if the firm's market area is changing, if there is a declining relevant population, or if technological or other changes may be creating an obsolete operation.

This kind of information can assist you in assessing trends in the level of the business's market penetration. For example, if its market share has been increasing then, perhaps you should anticipate further growth. However, if the business's market penetration has been declining or static, you should be aware that something could be wrong with the operation. It may be that the business is nearing the end of its life cycle. A shrewd seller, aware that his operation is approaching a natural decline, may be bailing out of the business before it sinks.

Competition facing the business must also be evaluated and understood. Foremost, you should make sure that the present owner will not remain in competition with you. Very often an owner will dispose of his business and open up a similar operation to compete with the purchaser of his old firm. For a business that is largely based on the personality and contacts of the owner, you may be hard pressed to maintain rapport with your present customers, suppliers, and financial sources. A legal agreement may be required in order to ensure that the vendor will not continue to compete with you.

Another aspect of competition deals with assessing the present competition faced by the firm. You should be aware of the business's major competitors and what trends can be foreseen in the nature of their competition. Most of this information can be obtained either from direct observation or by talking with other people in the business.

Other aspects of the environment also should not be overlooked in trying to determine the future prospects of the company. You must be tuned in to developments in the economy, changes in technology, government policy and regulations, and trends in society at large that can affect your business situation. Your banker or other professionals may be able to tell you what the experts are saying about future economic variables likely to affect your firm. Both national and regional economic factors must be studied in order to develop accurate projections as to the size of the market opportunity available to the business.

4. Human Factors

When a business is being purchased, manpower must be considered of equal importance with financial and marketing factors for it is usually desirable to retain certain key people in the business in order to provide some continuity. As a prospective buyer, you should assess the value of the company's personnel and try to become acquainted with the attitudes of the present employees. For example, will key employees continue to work for the firm under your management? If these key people will leave, you must anticipate the consequences.

Both the quality and quantity of trained personnel must be evaluated. The skill level of the employees has some bearing on the value of the business. Highly trained staff, for example, can increase the selling price. An inefficient and poorly trained staff, however, may suggest a lower purchase price with a long-term expense needed to be incurred in retraining or rehiring additional employees.

5. Other Concerns

There are a number of other factors you will also have to take into account in assessing a business to buy. These include various legal considerations as well as past company policies. The legal aspects of doing business are becoming increasingly more complex and the use of a lawyer is practically a fact of business life. A lawyer can help you in such areas as deciding on an appropriate form of legal organization; the identification of real estate documents such as zoning restrictions and coven-

ants that may put you at a disadvantage; advice on labor laws and union regulations; assistance in complying with all licensing and permit requirements; the transferability of intangible assets such as copyrights, patents, dealerships and franchises; and advice as to the most advantageous way of purchasing the company, either by buying the shares or the assets of the firm.

You should also have some understanding of the historical practices of the firm if future policies and practices are to enhance your opportunities for business growth. Past policy relating to employees, customers, and suppliers must be analyzed. An evaluation of these policies will determine if you should continue with present practice or make some modifications. Failing to do so, you may find yourself in a situation where you may have to continue policies that you do not like. Tightening of credit policies for example, may mean the loss of some customers or a change in labor practices may mean the loss of valuable employees.

IV

How to Determine an Appropriate Price to Pay for a Business

Buying a business is a serious matter involving a substantial financial and personal investment. A business bought at the wrong price, or at the wrong time, can cost you and your family much more than just the dollars you have invested and lost. After you have thoroughly investigated the opportunity represented by a business according to the factors in the previous section and weighed the wealth of information that you have gathered and decided that your expectations have been suitably fulfilled, a price must be agreed upon with the seller. Determining an appropriate price to pay to a business is a complex and technical process. If making this determination on your own you should have a sound knowledge of general accounting principals and evaluation techniques or use the services of a professional accountant.

Setting the purchase price for a going concern typically involves two different sets of valuations:

1. Evaluation of the firm's tangible net assets, and;
2. Evaluation of the firm's expected future earnings.

The tangible net assets or balance sheet methods for determining the value of a business are generally less reliant on estimates and forecasts than the earnings based methods. However, these balance sheet methods totally ignore the future earnings capability of the business.

1. Balance Sheet Methods

If the company has a balance sheet, the quickest means for determining a valuation figure is simply to look at its net worth as indicated by the balance sheet. You simply take the total assets as shown in the financial statement and subtract total liabilites. This is the "book value". The advantage of this method is that for most firms the numbers are readily available. Its drawbacks, however, are numerous. The company's accounting practices will have a big impact on its book value. Similarly, book value does not necessarily reflect the fair market value of the assets or the liabilities. For example, buildings and equipment shown on the balance sheet may be depreciated below their actual market value, or land may have appreciated above its original cost. These differences will not be reflected on the company's balance sheet. Despite these drawbacks however, book value may be useful in establishing a reference point when considering the asset valuation of a business. This approach is illustrated in Table 3 based on the balance sheet for the Appleton Company presented in Table 1.

To correct for differences from the real situation, you may wish to make some modifications to create a "modified book value." This modified book value is simply the book value adjusted for major differences between the stated book value and the fair market value of the company's fixed assets and liabilities. This refinement of the plain book value approach still has a number of drawbacks, but does, however, give a more accurate representation of the value of the company's assets at current market value than does book value. The application of this method is also illustrated in Table 3.

A third approach is to go beyond the books of the company to get a more detailed evaluation of specific assets. Generally this involves determining the "liquidation value" of the assets or how much the seller could get for the business or any part of it if it were suddenly thrown onto the market. This liquidation approach, indicating what the assets would fetch if the business were wound up, is ordinarily a highly conservative evaluation and, as such, is frequently useful in determining the lowest valuation in a range of values to be considered. (See Table 3)

2. Earnings Methods

In most cases, however, a going concern is much more than the sum of its physical assets. While the cost of reproducing or liquidating these assets can be closely determined, the cost of duplicating the firm's experience, management, technical know-how, and reputation is not so easily determined. These intangible factors will be reflected in the firm's past and expected future earnings.

Table 3
BUSINESS VALUATION—THE APPLETON CO.
"Balance-Sheet" Methods

	(000's)
I **Net Book Value**	
Total Stockholder's Equity (item E from Table 1)	$50
II **Modified Book Value**	
Net Book Vaue (above)	$50
Plus:	
Excess of appraised market value of building and equipment over book value	25
Value of patent not on books	10
Modified Book Value	$85
III **Liquidation Value**	
Net Book Value (above)	$50
Plus:	
Excess of appraised liquidation value of fixed assets over book value	9
Less:	
Deficit of appraised liquidation value of inventory over book value	(5)
Deficit due to liquidation of accounts receivable	(3)
Costs of liquidation and taxes due upon liquidation	(8)
Liquidation Value	$43

Since it is important to study past earnings trends, the trend must be true and representative. A period of five years is generally considered to be an appropriate length of time to observe an earnings trend. However, economic cycles and other factors must be taken into consideration when selecting the appropriate number of years to use.

Once earnings have been determined, various approaches can be used in order to determine an appropriate price. The most popular approach is a simple "capitalization of an average of past profits". In this method the profits for a selected period of years are adjusted for unusual items and an appropriate capitalization rate applied to the average profit level derived. (See Table 4, and Section I of Table 6.)

A variation of this method is to weight the earnings of prior years to give greater emphasis to more recent profit levels (for example, the most recent year is given a weight of 5, the previous year 4, the next previous year 3, and so on).

The major advantage of this approach is that it is easy to use. However, the selection of an appropriate capitalization rate or multiple to apply to past or expected future earnings is not a simple, straight-forward process. For illustrative purposes we have selected a desired rate of return of 16% or approximately 6 times earnings in Table 6 but the selection of any capitalization rate will, to some extent, be arbitrary.

The chosen capitalization rate is really an assessment of the risk you perceive to be related

IV

to the business. It is an indication of the rate of return you are prepared to accept for assuming that risk in relation to the rates of return you could earn from other, more secure investments such as Canada Savings Bonds, guaranteed income certificates, etc.

The selection of a capitalization rate can have a large impact on your evaluation of a business. If, for example, your desired rate of return is increase from 16% to 20% in Section 1 of Table 6, the estimated value of the Appleton Co. based on capitalization of their past earnings would be reduced from $60,000 to $48,000. The estimated values using discounted future earnings and discounted cash flow would be similarly reduced if we were to use a 20% rather than a 16% expected rate of return.

The "discounted future earnings" approach requires estimating after tax earnings for a number of years in the future as well as determining an appropriate rate of return for the investor. Each future year's earnings are then discounted by the desired rate of return. The sum of these discounted values is the estimated present value of the company. (Table 5 and Section II of Table 6.)

Table 4

The Appleton Co.
Summary of Earnings for Past Four Years

Year	Earnings After Taxes (000's)
19X9	$12.1
19X8	10.8
19X7	7.2
19X6	4.6

Table 5

The Appleton Co.
Projected Five-Year Earnings and Cash Flow

Year	Projected Earnings After Taxes (000's)	Projected Cash Flow (000's)
19Y1	16.9	14.0
19Y2	21.1	16.8
19Y3	26.4	20.2
19Y4	33.0	24.2
19Y5	41.2	29.0

Assumptions:

1. Earnings are expected to grow at a rate of 25% per year.
2. Cash flow is expected to grow at a rate of 20% per year.

Table 6

BUSINESS VALUATION—THE APPLETON CO.

"Earnings" Methods

I Capitalization of Earnings

Average Earnings Over Past Five Years (Tables 2 & 4)

	(000's)
19X6	$ 4.6
19X7	7.2
19X8	10.8
19X9	12.1
19Y0	13.5

Total $48.2—in the previous 5 years

Average Earnings $ 9.6

Divided by Investor's Desired Rate of Return 16% *

Value of Company Based on Capitalization of Past Earnings = 9.6 x 100/16 = $60.0

* The actual rate of return to use depends upon your cost of capital, as well as the preceived risk inherent in the investment.

II Discounted Future Earnings

	(1) Projected After Tax Earnings (Table 5) (000's)	(2) Present Value Factor— Assuming 16% Return	Present Value of After Tax Earnings (1) x (2) (000's)
19Y1	$16.9	.862	$14.6
19Y2	21.1	.743	15.7
19Y3	26.4	.641	16.9
19Y4	33.0	.552	18.2
19Y5	41.2	.476	19.6
Total	$138.6		$85.0

Value of Company Based on Discounted Future Earnings is: $85.0

III Discounted Cash Flow

	(1) Projected Cash Flow (Table 5) (000's)	(2) Present Value Factor— Assuming 16% Return	Present Value of Projected Cash Flow (1) x (2) (000's)
19Y1	$14.0	.862	$12.1
19Y2	16.8	.743	12.5
19Y3	20.2	.641	13.0
19Y4	24.2	.552	13.4
19Y5	29.0	.476	13.8
Total	$104.2		$64.8

Value of Company Based on Discounted Cash Flow is: $64.8

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The advantage of this approach is that future earnings potential becomes the principal investment criteria, taking into account the time value of money. The principal disadvantage is that in many situations, future earnings can not be projected with any real accuracy because of the uncertainties of the operating environment and the marketplace.

The "discounted cash flow" approach is essentially the same as discounted future earnings except that future anticipated cash flows rather than earnings are used in the computation as seen is Section III of Table 6. Like the discounted future earnings approach, this method of valuation also depends upon estimates and assumptions which are highly uncertain. Many people feel, however, that this method and the discounted future earnings method typically provide the most reasonable estimates of a company's value.

Each of these evaluation methods is illustrated for the case of the Appleton Company. The following assumptions are reflected in these calculations.

1. Future earnings are estimated with new management in place.
2. Earnings are expected to grow at a rate of 25% per year.
3. The income tax rate, including federal and provincial income taxes, is 25%
4. Your desired return on investment is 16%

As illustrated in Table 7, the values of the Appleton Company vary widely depending upon the valuation method used. The actual value of the company will depend upon which method is the most appropriate for the circumstances. For example, the seller will argue that the valuation method yielding the highest value—modified book value or discounted future earnings—is the most appropriate one. While you would argue that the one reflecting the lowest value for the business—liquidation value—is probably the most appropriate. The price that will actually be agreed upon will result from extensive negotiation between you and the prospective seller and will involve considering not only these formal evaluation methods but a host of other business and personal considerations as well.

3. The Rule of Thumb Approach

In some situations, primarily service industries, certain rules of thumb have been developed to serve as useful guides for the valuation of a business. One common rule of thumb in firms where there are substantial assets is to add up the fair market value of the company's fixed assets, plus the owner's cost of current inventory, plus approximately 90% of what appear to be good accounts receivable, plus a percentage of the company's net income before taxes as good will. In company's where there are relatively few tangible assets, another rule of thumb is to calculate the selling price as a percentage of the gross annual receipts of the business.

Table 7

THE APPLETON CO.

Summary of Results

	Estimated Value (000's)
Net Book Value (Table 3)	$ 50
Modified Book Value (Table 3)	85
Liquidation Value (Table 3)	43
Capitalization of Earnings (Table 6)	60.0
Discounted Future Earnings (Table 6)	85.0
Discounted Cash Flow (Table 6)	64.8

Using one of these rules of thumb does not mean that the balance sheet and the income statement for the business can be completely ignored. These rules are merely a starting point for business valuation and must be reviewed in the context of the other business factors discussed earlier in this section.

4. What to Buy—Assets or Shares?

The acquisition of a business may be structured under one of two basic formats:

1. You can purchase the seller's stock.
2. You can purchase part or all of the seller's assets.

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Although these forms are treated somewhat the same for financial reporting purposes, the tax consequences can vary significantly. A major consideration in the purchase or sale of a business may be the affect on the tax liability of both the buyer and the seller. The "best" form of a particular transaction will depend on the facts and circumstances of each case. Since the tax implications of acquiring or disposing of a business can be very complex, and a poorly structured transaction can be disasterous for both parties, it is suggested that you seek competent tax advice from your accountant or lawyer regarding this matter.

In some cases there may not be any choice. If the company is a sole proprietorship, for example, there are no shares, only assets and liabilities accumulated in the course of doing business which belong to the proprietor personally. So when acquiring the company, you and the owner must decide which of these assets and liabilities are to be transferred and which are to stay with the present owner. You may feel that some of the assets are not really essential to carry on the business and the seller may desire to keep something, often the real estate which you may be able to lease rather than buy from him. This may be one way of reducing the cost of the business to you. These are matters which would have to be discussed in detail between you and the prospective seller.

V

The Advantages and Disadvantages of Buying an Existing Business

The case for buying an existing firm against setting up a new one of your own is not clear cut either way. Each situation must be decided on its merits. There are distinct advantages and disadvantages to each course of action. You must consider how well your personal preferences fit into each of these options.

1. Reasons for Buying an Established Business

a. Buying an existing business can reduce the risk factor. The existing business is already a proven entity. It is often easier to obtain financing for an established operation rather than a new one.

b. Acquiring a going concern with a good past history increases the likelihood of a successful operation for the new owner.

c. The established business has a proven location for successful operation.

d. The established firm already has a product or service that is presently being produced, distributed, and sold.

e. A clientele has already been developed for the product or service of the existing company.

f. Financial relationships have already been established with banks, trade creditors, and other sources of financial support.

g. The equipment needed for production is already available and its limitations and capabilities are known in advance.

h. An existing firm can often be acquired at a good price. The owner may be forced to sell the operation at a low price relative to the value of the assets in the business.

2. Disadvantages of Buying an Established Business

a. The physical facilities (the building and equipment) and product line may be old and obsolete.

b. Union/management relationships may be poor.

c. Present personnel may be unproductive and have a poor track record.

d. The inventory may contain a large amount of "dead stock".

e. A high percentage of the assets may be in poor— quality accounts receivable.

f. The location of the business may be bad.

g. The financial condition of the business, and its relationships with financial institutions, may be poor.

h. As a buyer, you inherit any ill will that may exist for the established firm amongst customers or suppliers.

i. As an entrepreneur you have more freedom of choice in defining the nature of the business if you start one of your own than if you purchase an existing firm.

As you can see there are both pluses and minuses in choosing to acquire an established business. You should view this option in terms of whether it will enable you to achieve your personal objectives. How do these advantages/disadvantages compare with those of starting a new business of your own? In buying an existing business do you see a reasonable opportunity to succeed? No one else can really advise you what to do. Instead, you must "do your own thing" and match the alternatives with your abilities and interests.

VI

Checklist for Business Acquisition

Should you start a new business or buy an existing one? At this point in your deliberations, this is the critical question. The material in this questionnaire will aid you in making this choice.

If, after answering the questions in Part A, you decide to enter an established business rather than to start one of your own, then you should proceed to the questions in Part B. You may want to reproduce these pages and answer the same questions for several businesses you have in mind. Go through the questionnaire and answer the questions concerning each business as conscientiously as you can.

PART A

Before deciding whether you will purchase an established business, you need to give consideration to the positive and negative features of this alternative. You should rate each point in the questionnaire as you perceive the significance of the point and its importance to you.

1. How would you define the nature of the business you are interested in?:

   _____

   _____

   _____

   _____

   _____

2. How important are each of the following factors to you in electing to buy an established business? Indicate the importance of each factor to you on a scale ranging from 0—not important at all, to 10—extremely important.

   a. Having a business with a proven performance record in sales, reliability, service, and profits. ____

   b. Avoiding the problems associated with assembling the composite resources—including location, building, equipment, material and people. ____

   c. Avoiding the necessity of selecting and training a new work force. ____

   d. Having an established product line. ____

   e. Avoiding production problems typically associated with the start-up of a new business. ____

   f. Having an established channel of distribution to market your product. ____

   g. Having a basic accounting and control system already in place. ____

   h. Avoiding the difficulty of having to work out the "bugs" that commonly develop in the initial operation of a new business. ____

   i. Having established relationships with suppliers and financial institutions. ____

   j. May be able to acquire the assets of the business for less than their replacement value. ____

   TOTAL ____

3. In checking back over the points covered in section 2, the closer your total score on all items is to 100, the more that purchasing an established business is likely to be of interest to you as a means of going into business for yourself.

PART B

The following is a set of considerations to be assessed in evaluating an established business. Your responses, information from the present owner, and other information concerning the status of the business should guide you to a comfortable decision as to whether this business is for you.

1. Why is the business for sale?

   _____

   _____

   _____

   _____

   _____

   _____

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2. Financial Factors:

a. Recent sales trend:

Increasing substantially ____
Increasing marginally ____
Relatively stable ____
Decreasing marginally ____
Decreasing substantially ____

b. Recent trend in net profit:

Increasing substantially ____
Increasing marginally ____
Relatively stable ____
Decreasing marginally ____
Decreasing substantially ____

c. Are the financial statements audited?

Yes ____ No ____

d. Apparent validity of financial statements:

Accurate ____
Overstated ____
Understated ____

—Check:
—Relationship of book value of fixed assets to market price or replacement cost.
—Average age of accounts receivable and percentage over 90 days.
—Bad debts written off in the past 6 months, 12 months.

e. Ratio Analysis:

	This Company			
	Industry Standard	Year to Date	Last Year	Two Years Ago
(1) Current Ratio				
(2) Quick Ratio				
(3) Debt to Net Worth Ratio				
(4) Gross Profit to Sales Ratio				
(5) Net Income to Sales Ratio				
(6) Return on Assets				

3. Tangible Assets

a. Are the land and buildings adequate for the business?

Yes ____ No ____

b. Is the location acceptable?

Yes ____ No ____

c. Is the machinery and equipment worn and out of date?

Yes ____ No ____

d. How does it compare with the latest available?

_____

_____

_____

_____

_____

_____

e. What is the maintenance status of the plant and equipment?

Excellent ___ Good ___ Fair ___ Poor ___

f. Is the plant of sufficient size and design to meet your current and projected requirements?

Yes ____ No ____

g. Does the plant appear to be well laid out for the efficient use of people, machines, and material?

Yes ____ No ____

h. What is the approximate value of the company's inventory?

Raw material $_____
Work-in-Process $_____
Finished Goods $_____
TOTAL $_____

i. Does the inventory contain a high proportion of obsolete or "dead" stock?

Yes ____ No ____

4. Intangible Assets

a. Does the company name or any of its tradenames have any value?

Yes ____ No ____

b. What kind of reputation does the business have with its *customers*?

Positive ____ Neutral ____ Negative ____

c. What kind of reputation does the business have with its *suppliers*?

Positive ____ Neutral ____ Negative ___

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d. Are any franchise, licensing or other rights part of the business?

Yes _____ No _____

Are they included in the deal?

Yes _____ No _____

e. Are any patents, copyrights or trademarks part of the business?

Yes _____ No _____

Are they included in the deal?

Yes _____ No _____

5. Marketing Factors

a. Is the market for the firm's product/service?

Increasing ____ Stable ____ Declining ____

If *declining*, is this principally attributable to?

(1) decreasing demand due to lower popularity _____

(2) a changing neighborhood _____

(3) a declining target population _____

(4) technological change _____

(5) lack of effort by present owner _____

(6) other factors _____

6. Human Factors

a. Is the present owner in good health?

Yes _____ No _____

b. Does the present owner plan to establish a new business or acquire another business that would put them in competition with you?

Yes _____ No _____

What are the intentions of the present owner?

_____

_____

_____

_____

c. How efficient are current personnel?

(1) What is the rate of labor turnover? ___%

(2) What is the rate of absenteeism? ___%

(3) What proportion of production is completed without rejects? ___%

(4) Can you accurately determine the cost of producing an individual unit of the product or service?

Yes _____ No _____

—How has this changed in the past year?

Increased ____ Stayed the Same ____

Decreased ____

d. Has a union recently won an election to serve as a bargaining agent for the company's employees?

Yes _____ No _____

e. Will most of the key employees continue to work for the firm under your management?

Yes _____ No _____

f. Will you have to incur considerable costs in retraining or rehiring additional employees?

Yes _____ No _____

7. Other Considerations

a. Are there any zoning restrictions or caveats on the property that may put you at a competitive disadvantage?

Yes _____ No _____

b. Can you satisfy all the federal and provincial licensing and permit requirements?

Yes _____ No _____

c. Have you considered what would be the most advantageous way of purchasing the company?

Buy Shares ____ Buy Assets ____

Don't Know ____

d. Have you had a lawyer and an accountant review the material you received from the vendor and any other information you may have regarding the business?

Lawyer: Yes ____ No ____

Accountant: Yes ____ No ____

8. Your Evaluation of the Business

What have you determined to be the approximate value of the business based on:

a. Net Book Value $_____

b. Modified Book Value $_____

c. Liquidation Value $_____

d. Capitalization of Past Earnings $_____

e. Discounted Future Earnings $_____

f. Discounted Cash Flow $_____

VI

The areas covered by this checklist are not meant to be exhaustive but are presented to guide and stimulate your own thinking about buying an existing business. The more information you can compile to assist you in making this decision the better.

In your search for more information do not overlook the other publications available from the Business Resource Centre, but do not restrict your efforts to only these publications. There is a lot of useful material available from other sources as well.